

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:WAS:TL-N-4521-00
WABaker

date: DEC 20 2000

to: Team Manager, Natural Resources, Baileys Crossroads, Virginia

from: Associate Area Counsel, Delaware-Maryland District, Washington,
D.C.

subject: [REDACTED]

This is in response to your request dated July 28, 2000 for assistance regarding the proper timing of income recognition on income tax returns you have under examination for the subject taxpayer for calendar years [REDACTED], [REDACTED], and [REDACTED]. On [REDACTED], we met with you, your examiner, and taxpayer's representatives. After that meeting, we requested taxpayer's income tax return and administrative file for calendar year [REDACTED] from the Philadelphia Service. We have received and reviewed the administrative file, and are now in a position to provide you the requested advice.

ISSUE:

Whether, under the circumstances described below, taxpayer changed its method of accounting for extended maintenance contracts without obtaining consent from the Commissioner as required under I.R.C. § 446(e).

FACTS:

During the years under examination, [REDACTED] ("taxpayer") was wholly owned by [REDACTED], a [REDACTED] computer software corporation. Taxpayer primarily licensed and serviced computer software products of its parent and paid royalties on the licensing agreements to its parent. During all relevant periods, taxpayer used the accrual method of accounting and reported that it had no inventory for financial and tax purposes. During the years currently under examination taxpayer's licensing agreements were fixed price contracts.

Extended maintenance contracts refers to the portion of a fixed-price, licensing agreement that remains executory after computer software is transferred to a customer. The executory provisions may include obligations to educate and train customer

employees, correct errors in the computer software, and keep the computer software updated.

Prior to [REDACTED], taxpayer recognized income from licensing agreements for both book and tax purposes "at the time it issued an invoice for these services." Letter dated [REDACTED] from [REDACTED] to Revenue Agent Frank B. Buell Jr. (emphasis added). See Attachment 1 hereto. At the time of the letter, taxpayer referred to extended maintenance contracts as "technical service contracts." Taxpayer also claimed that "[t]hese contracts run for a 12-month period of time." Ibid.

On April 27, 1987, the American Institute of Certified Public Accountants ("AICPA") issued Issue Paper 87-1, Software Revenue Recognition. Taxpayer, beginning with its fiscal year ended December 31, [REDACTED], complied with the advisory conclusions reached by the AICPA and recognized income from extended maintenance contracts ratably over 12 months on its financial statements. See Attachment 1 hereto.

On [REDACTED], while taxpayer's income tax returns for tax years ended May 31, [REDACTED] through calendar year [REDACTED] were under examination, taxpayer's representative ([REDACTED]) asked the examiner to change taxpayer's method of accounting for both extended maintenance contracts and for leases of software products. Ibid. As to extended maintenance contracts, taxpayer contended that because they were "service contracts" taxpayer should be permitted to use the special method of accounting permitted by Rev. Proc. 71-21, 1971-2 C.B. 549, with calendar year [REDACTED] as the year of change. See Attachment 1 hereto.

The examiner and his group manager decided that either the accrual method of accounting used by taxpayer prior to [REDACTED] or the special method of accounting permitted by Rev. Proc. 71-21 would clearly reflect taxpayer's income. See Attachment 2 hereto. Therefore, in order to settle the case at the examiner's level, taxpayer's requests were granted using Rev. Proc. 92-20, 1992-2 C.B. 685; however, the year of change was calendar year [REDACTED], not [REDACTED] as requested.¹ See Attachment 2 hereto. A copy of the revenue agent report (Form 4549) is attached hereto as Attachment 3.

As a result of the accounting method changes, adjustments were required under I.R.C. § 481(a). The adjustment for extended maintenance contracts was a negative \$ [REDACTED]. See Attachment 4 hereto. The adjustment required under I.R.C. § 481(a) for

¹ Rev. Proc. 92-20 was modified and superseded by Rev. Proc. 97-27, 1997-1 C.B. 680.

leases of software products was a negative \$ [REDACTED]. See Attachment 5 hereto. It was further agreed that the adjustments would be spread over six years pursuant to Rev. Proc. 92-20.

Although the revenue agent report shows the adjustments required under I.R.C. § 481(a), it contains no narrative explanation for the changes in method of accounting. There was no closing agreement under I.R.C. § 7121. The revenue agent's report was accepted by the Richmond District Director. Taxpayer was assessed deficiencies and given credit for overpayments.

Subsequently, taxpayer changed the term of its extended maintenance contracts to between [REDACTED] and [REDACTED] years. Also, on [REDACTED], Technical Advice Memorandum [REDACTED] ("TAM [REDACTED]") was issued with the following conclusions:

(1) [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

(2) [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

(3) [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

(Emphasis added.)

On December 12, 1991, AICPA Statement of Position 91-1, Software Revenue Recognition, ("SOP 91-1") was issued to provide "guidance on when revenue should be recognized and at what amounts for licensing, selling, leasing, or otherwise marketing computer software." SOP 91-1 was effective for financial statements issued after March 15, 1992, and taxpayer complied with it. Taxpayer, on its income tax returns currently under examination, deferred its income from extended maintenance contracts ratably over the term of the contracts, between [REDACTED] and [REDACTED] years.

Taxpayer contends, without citing any authority, that by changing the term of its extended maintenance contracts to between ■ years and ■ years there was a change in facts which justified a change in method of accounting without obtaining consent from the Commissioner. Taxpayer also cites TAM ■ for the proposition that the proceeds under its extended maintenance contracts are from the sale of goods, not services, and that it is entitled to use the exception for inventoriable goods provided in Treas. Reg. § 1.451-5(c).

Taxpayer proposes that the examiner should, for the tax years under examination, allow it to allocate the fixed price of each licensing agreement among the following: (1) the licensing agreement, (2) executory provisions to be performed in the year succeeding the agreement (using Rev. Proc. 71-21), and (3) executory provisions to be performed after the end of the tax year immediately succeeding the year of the agreement (using Treas. Reg. § 1.451-5(c)). Taxpayer's representatives told the examiner that the proposed allocation would result in an agreed case with audit adjustments in the years under examination.

DISCUSSION:

Income is includible in gross income under the accrual method of accounting when all the events have occurred which fix the right to receive the income and the amount of income can be determined with reasonable accuracy. Treas. Reg. § 1.451-1. Prior to the Service's examination of taxpayer's income tax returns for calendar year ■, taxpayer recognized income from licensing agreements at the time it issued an invoice to its customers.

During the examination of taxpayer's calendar year ■ income tax return, taxpayer represented to the Service that its extended maintenance contracts qualified as service contracts under Rev. Proc. 72-21. The Richmond District Director permitted taxpayer to retroactively (beginning with calendar year ■) change its method of accounting for the extended maintenance contracts.

The purpose of Rev. Proc. 71-21 is "to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year." Id. at § 1. Rev. Proc. 71-21 is available to "[a]n accrual method taxpayer who, pursuant to an agreement (written or otherwise) receives a payment in one year for services, where all of the services under such agreement are

required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year..."

During the years under examination taxpayer changed the term of its extended maintenance contracts to between ■ and ■ years. This was a change in underlying fact, and as a result of this change in fact taxpayer could not use the special method of accounting permitted by Rev. Proc. 71-21 for these contracts. See Rev. Proc. 71-21, § 3.03. Taxpayer did not request or receive consent to use another special method of accounting for these contracts, e.g., Treas. Reg. § 1.451-5. Therefore, taxpayer must recognize income from these contracts using its accrual method of accounting, i.e., at the time it issues an invoice to its customers.

Taxpayer argues that its extended maintenance contracts qualify as "agreements" for the sale of goods within the meaning of Treas. Reg. § 1.451-5(a)(1)(i) and for the inventorable goods exception of Treas. Reg. § 1.451-5(c). Whether taxpayer's extended maintenance contracts are for the sale of goods or services is a question of fact, which does not need to be resolved for purposes of this advisory opinion. However, we note that the conclusions reached in the ■■■■■ technical advice memorandum cited by taxpayer have never been published in a revenue ruling, revenue procedure, or Treasury regulation. Moreover, taxpayer has never reported the existence of an inventory on any financial statement or income tax return. Compare Straight v. Commissioner, T.C. Memo 1997-569 ("We conclude that the payments at issue were not advance payments under section 1.451-5(a)(1)(i), Income Tax Regs., because [taxpayer] did not hold [goods] for sale to customers in the ordinary course of business.").

Taxpayer may not change its method of accounting for extended maintenance contracts to the special method of accounting permitted by Treas. Reg. 1.451-5 without first obtaining the consent of the Commissioner. I.R.C. § 446(e).² Rev. Proc. 97-27, 1997 C.B. 680, provides the general procedures for obtaining the consent of the Commissioner, which includes filing an Application for Change in Method of Accounting (Form 3115) during the year of change. Id. at § 5.01.

² Authority has not been delegated to either examiners or territory managers to give consent to a change in method of accounting under I.R.C. § 446(e).

CONCLUSION:

Under the circumstances described above, taxpayer changed its method of accounting for extended maintenance contracts without obtaining consent from the Commissioner as required under I.R.C. § 446(e). Therefore, during the years under examination, taxpayer must recognize income from extended maintenance contracts with terms of ■ to ■ years using its accrual method of accounting, i.e., at the time it issues an invoice to its customers.

If you have a question, please contact Special Litigation Assistant Wilton A. Baker. His telephone number is (202) 634-5402, ext. 269.

By: _____
BETTIE N. RICCA
Associate Area Counsel (LMSB)

Attachments:

- (1) Letter dated ■ from ■ to Revenue Agent Frank B. Buell Jr.
- (2) Examiner's working papers for change in method of accounting
- (3) Revenue Agent Report (Form 4549) for ■, ■, ■, ■, ■, and ■
- (4) Examiner's working papers for I.R.C. § 481 adjustment for extended maintenance contracts
- (5) Examiner's working papers for I.R.C. § 481 adjustment for leases of software products